STATEMENT OF NANCY E. McFADDEN
GENERAL COUNSEL
U.S. DEPARTMENT OF TRANSPORTATION

before the

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

June 21, 2000

Mr. Chairman, Ranking Member Hollings, and Members of the Committee:

I appreciate the opportunity to come before the Committee to discuss the state of airline competition and to describe the Department of Transportation's role in reviewing airline mergers and acquisitions. The hearing today is precipitated by the announcement by United Airlines and US Airways of a major merger proposal.

On behalf of Secretary Slater, I want to assure the Committee that we will maintain our commitment to preserving airline competition in order to ensure that consumers through the United States continue to benefit from airline deregulation, and that this proposed transaction, indeed any major transaction, will be thoroughly examined by the Department of Transportation with the goal of preserving competition in the airline industry.

We cannot, of course, discuss the specifics of any individual transaction. However, we understand the Committee's great interest in this matter, and so I would like to describe generally how the Department examines any such transaction.

My testimony today will cover three subjects: some background to the current state of competition in the airline industry, the Department's role in reviewing airline mergers and acquisitions, and the factors that we will look at in analyzing a merger or acquisition.

The structure of the airline business today reflects Congress' decision to deregulate the industry in 1978. Congress correctly determined that the public would obtain better service and fares if airlines had to respond to consumer demands and competition. Congress therefore phased out the economic regulatory regime that had long authorized the Civil Aeronautics Board to dictate where airlines could fly and what they could charge.

In responding to market demands and the need to improve their efficiency, airlines literally reshaped their point-to-point route systems into hub-and-spoke systems. Hub-and-spoke systems enable airlines to serve the maximum number of city-pair markets with a minimum number of airplanes and to maximize traffic flow by consolidating connecting passengers with different destinations on each flight. Operating at a hub creates service advantages for many travelers, since it gives travelers at hub cities many more flights and enables airlines to offer more service in markets that do not have enough traffic to sustain non-stop service. On the other hand, an airline operating a hub gains such great competitive advantages on the spoke routes at its hub that other airlines without a hub at one end point of such a spoke route find it hard to compete with the hubbing airline. The resulting lack of competition in many hub routes usually causes fares in hub markets to be higher than fares in comparable non-hub markets.

Another development in the first years after deregulation was new entry--quite a few firms entered the airline business (or began interstate service for the first time). Relatively few survived the 1980's, but one of those that did--Southwest Airlines--has since expanded its low-fare operating strategy throughout most of the country. Two other entrants of that era--America West and Midwest Express--are also operating successfully today.

The 1980's saw a wave of airline mergers. At that time, federal law still required all such transactions to obtain the prior approval of the Department of Transportation. The Department approved almost all of the merger proposals submitted to it before the complete phasing-in of deregulation ended the Department's approval authority over airline mergers and acquisitions. Since the end of 1988, the Department of Justice has been responsible for determining whether mergers and acquisitions in the airline business should be challenged as anticompetitive.

In the 1990's, airlines developed new strategies for delivering their services. They viewed the ability to offer a broader network of services as critical. This led to the creation of alliances in both domestic and international markets that included code-sharing arrangements and frequent flyer program reciprocity.

The development of international alliances has been part of the larger process of globalization. Responding to this increasing globalization, the Clinton-Gore Administration has worked hard to open up international markets to competition and entry by U.S. airlines. In the last seven and one-half years, the United States has reached open skies agreements with forty-six countries that allow any U.S. airline to serve points in those countries from any U.S. point and to set fares free of government regulation. As a result of these successful efforts,

we have seen the development of global airline alliances that have promoted competition in thousands of city-pair markets throughout the world.

More recently, major U.S. airlines began forming alliances with one another. In 1998, United planned an alliance with Delta, Northwest with Continental, and American with US Airways. These domestic alliances were different from the international alliances. The latter usually created new networks by linking route systems of U.S. and foreign airlines on an end-to-end basis and involved airlines that could not enter each other's domestic markets due to the constraints of bilateral aviation agreements. The alliances between U.S. airlines, on the other hand, involved airlines that already had the authority to enter any domestic market. These alliances were potentially more problematic.

In the face of these proposed domestic alliances, Congress enacted legislation requiring the major airlines to submit to the Department of Transportation any joint venture agreements between them that covered frequent flyer programs, code-sharing, and wet leases. The Department has used that authority to obtain modifications that eliminated potentially anticompetitive features in joint venture agreements. In addition, the Justice Department filed suit against Northwest's acquisition of the major block of Continental stock. The other two alliances – the United / Delta and American / US Airways alliances – have not gone beyond frequent flyer reciprocity arrangements and provisions for the reciprocal access to airport executive lounges.

In the 1990's, we also saw increased focus on the value of new airline entrants, especially their presence in dominated-hub markets, and the difficulties faced by those new entrant carriers. This Committee has spent much time over the past few years looking into airline competition and impediments to new entry. You have addressed this issue most recently in several pro-competition provisions in AIR-21, the FAA reauthorization act signed into law in April of this year. As you know, for example, the bill included a provision that airports dominated by one or two carriers must file a competition plan with the Department before raising passenger facility charges. And the DOT has taken a number of steps to promote competition and protect against anticompetitive practices. For example, the Department has focused on the possibility that the joint travel website being created by five major airlines might operate in a way that may reduce competition in the airline industry and the airline distribution business. The Committee has also had questions about the website and intends to hold a hearing on the subject. The Department has begun a study of the website firm, Orbitz, originally called T2, and recently asked Orbitz to provide detailed information on its organizational and operational plans and to provide copies of relevant documents.

As a result of all these developments, we have an industry that, for the most part, has proven deregulation to be a success. But deregulation can only be successful for the consumers it was meant to benefit if there is adequate competition in the airline industry. That is why close scrutiny of the proposed merger between United and US Airways is critical for the country's airline travelers.

I paint this backdrop to give a sense of the state of airline competition, but also to make two points. First, we have learned a lot about the airline industry over the past 15 years from these developments. We simply have a greater understanding of how airlines act and react in a deregulated environment. And second, the Justice Department and the Department of Transportation, particularly over the past seven and a half years, have shown the ability and will to work to preserve airline competition, often working hand in hand with Congress. We will bring to bear, as we closely scrutinize any proposed merger, the experience and expertise we have honed over the past 15-20 years, as well as the will and ability to act to preserve competition.

Let me now address the role the Department of Transportation plays in the review of airline mergers and acquisitions. Both the Department of Justice and the Department of Transportation have responsibilities for reviewing the proposed transaction between United and US Airways.

The Justice Department is responsible for enforcing the antitrust laws and determining whether mergers and acquisitions in the airline industry should be challenged on competitive grounds. The statute now governing airline mergers, section 7 of the Clayton Act, prohibits mergers and acquisitions that may substantially lessen competition in any relevant market or tend to create a monopoly.

The Department of Transportation will conduct its own analysis of the merger and submit its views and any relevant information in its possession to the Justice Department, as we have done in past cases. This process is confidential. We have asked United and US Airways to provide us all the information necessary to thoroughly analyze the transaction. In doing that analysis, we will also rely on the fare and traffic data periodically reported to us by the airlines.

In addition, the Department has separate regulatory authority and must grant its approval before some parts of the transaction may go forward. First, the parties have announced plans to spin off most of US Airways' operations at Washington Reagan National Airport to a new airline. This new airline must obtain economic operating authority from the Department as well as safety authority from the FAA. In determining whether to grant economic operating authority, we will determine whether the firm is "fit, willing, and able" to perform air

transportation and comply with applicable legal requirements. In making fitness determinations, we review an airline's financial resources, managerial capabilities, and compliance disposition. The FAA, under its safety authority, conducts a separate, comprehensive safety fitness analysis of the new carrier before issuing the Air Carrier Certificate and Operations Specifications.

Second, the proposed acquisition will also involve the transfer of US Airways' international route authority in some limited-entry markets. Here too, the Department must first approve the transfer of US Airways' certificate authority, under 49 U.S.C. 41105. We may approve a transfer only if we find that it is consistent with the public interest. The Department by statute must specifically consider the transfer's impact on the viability of the parties to the transaction, on competition in the domestic airline industry, and on the trade position of the United States in the international air transportation market. The Department will also examine any other public interest issue raised by the transfer.

The Department will only decide whether to approve the transfer of the international route authority after it has established a formal record and given all interested persons the opportunity to comment on the proposed transfer. The Department's discussions with the Justice Department on the overall merger will include a discussion of the competitive effects of the transfer of US Airways' international routes. If the Department determines that the transfer would be contrary to the public interest on competitive grounds or for another reason, the Department may disapprove the transfer in whole or part. Alternatively, the Department may condition its approval on requirements that would protect the public interest.

Third, the Department additionally has the obligation to protect consumers from unfair and deceptive practices by airlines. In carrying out that responsibility, we will review the merger's arrangements to protect the rights of consumers. For example, the merger may well affect the existing reciprocity benefits available to members of the United and US Airways frequent flyer programs. We will look at whether the airlines will give consumers reasonable notice and an opportunity to adjust to any changes in such programs. If we find that the provisions in their frequent flyer agreements fail to provide adequate notice and an opportunity to obtain award travel, we will ask the airlines to modify the agreements. Accordingly, we have asked United and US Airways to provide us with their relevant frequent flyer program reciprocity agreements, and their plans for accommodating their members concerning any potential changes.

Finally, I would like to outline the factors we will consider in our competitive analysis of the proposed United/US Airways merger. We will be looking at the merger's likely impact on competition in all relevant markets. We will examine

such issues as whether the acquisition will substantially reduce competition in relevant markets because other airlines either do not offer effective competition now or will be unlikely to enter if United raises fares or reduces service. A key question will be whether the proposed spin-off of US Airways' operations at Reagan National to DC Air will create an effective competitor in the Washington, D.C. markets affected by the merger.

The relevant markets include city-pair markets, both those served by the parties with nonstop flights and those served with connecting flights. In examining the markets affected by the merger, we may well consider flights operated by United from one airport in the same metropolitan area as competing with flights operated by US Airways from a different airport in the same area. If a significant number of travelers strongly prefer to use one airport, the relevant markets may also include routes between specific airports. In analyzing whether entry by other airlines into markets served by the combined airlines is likely, the Department will examine whether the combined market share of the merging airlines will become large enough at individual cities to discourage entry by other airlines. We must also consider whether airport facilities will be available to airlines wishing to enter markets served by United and US Airways.

We will additionally investigate whether the relatively large size of the airline created by combining United and US Airways will make entry into the industry by new airlines more difficult. We will also examine the potential competitive reactions of other airlines.

Looking at the merger's competitive effects will carry out Congress' judgment that market forces, not government regulators, should determine the routes flown by airlines and the fares charged by airlines. But market forces will enable consumers to obtain the best service at the best price only as long as the airline industry is competitive.

Members of Congress and local communities have understandably expressed concern about whether the service now provided by US Airways will be maintained after its acquisition by United. For example, some communities have questioned whether they will continue to have access to nonstop flights to Reagan National. We cannot directly answer these questions, since we cannot predict United's long-term plans for operating the combined business, and we have no way to guarantee that United or DC Air would maintain existing levels of service. Nor can we know whether other airlines--existing or new--might choose to inaugurate new services to these communities. Under deregulation, each airline decides for itself which routes it will fly and what fares it will charge. However, together with the Justice Department, we will seek to ensure that the proposed merger does not diminish competition and prevent other airlines from

entering and competing in markets where United may reduce service or raise fares. The key question in determining whether the United / US Airways acquisition will lead to better or worse service and fares for consumers is whether the combined airline will face competition and therefore must meet the demands of consumers. The Justice Department will address that question by applying the antitrust laws. We at the Department of Transportation will provide the Justice Department with the results of our own analysis of that question.

Because of the Committee's longstanding interest in airline consumer protection issues, I would like to provide a brief status report on some of the actions the Department has already taken to implement the passenger rights provisions contained in AIR-21, the Wendell H. Ford Aviation Investment and Reform Act for the 21st Century. For example –

- We have notified foreign carriers of their new obligations under the law to comply with the Air Carrier Access Act.

- We issued rules to implement the new smoking prohibitions that apply, for the first time, to foreign carriers flying to and from the U.S.

- We have notified all U.S. and foreign carriers of their new statutory obligations to add additional assurances for survivors and families of victims of aircraft accidents in airline family assistance plans on file with DOT and the NTSB.

- We have implemented procedures to enable us to investigate each Air Carrier Access Act complaint received by DOT.

- We will be meeting shortly with the Justice Department, National Council on Disability, and the Access Board to develop an outreach plan to provide information and technical assistance to air carriers and members of the disability community regarding Air Carrier Access Act requirements.

- An advisory committee will soon be established to assist us in complying with the AIR-21 provision requiring the reporting of the nature and causes of flight delays.

- In the next month or two, we will begin to report complaints regarding the death, injury and loss of animals in air transportation as a separate category in our monthly Air Travel Consumer Report.

- We have already reported to Congress on the filing of voluntary customer service plans by the Air Transport Association carriers.

I would also note that, before AIR-21 was signed into law, we had doubled the minimum baggage liability limit imposed on domestic carriers and had begun to list Air Carrier Access Act complaints separately in our Air Travel Consumer Report. We will continue to treat airline consumer protection issues, in general, and the implementation of the AIR-21 mandated passenger rights provisions, in particular, with the highest priority. I must point out to the Committee, however, that without the additional funding provided by AIR-21 for consumer protection compliance and enforcement activities, the benefits to passengers of AIR-21 will largely be lost. Notably, the Senate-passed appropriations bill for the Department contains no additional funds for airline consumer protection activities, and the House-passed bill contains only an additional $300,000 for this purpose, far short of the $1.4 million requested by the Administration. We hope that this Committee will work to ensure the needed funding in the upcoming fiscal year.

In conclusion, I wish to reaffirm our commitment to ensuring that consumers throughout the United States continue to benefit from airline deregulation. That will require us to continue our efforts to promote airline competition. The need to ensure competition will both guide our review of the United / US Airways transaction and guarantee that we will carefully examine its potential impact, and it will underpin the use of our other economic regulatory authority over the airline industry.

Thank you Mr. Chairman. This completes my prepared statement, and I would be pleased to respond to your questions and those of the Committee.